An Energy Efficiency Workshop & Exposition
Palm Springs, California

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Setting and Hedging Interest Rates

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Setting the Interest Rate

- Spread to UST determined by the following factors:
  - Term
  - Amount
  - Project Risk
  - Contractor Risk
  - Contract Terms

Spread Factors

- Lenders / Investors price to "weakest link":
  - Term – longer is more risky
  - Amount – small is diminished profit potential
  - Project Risk – M & V, set-off risks
  - Contractor Risk – credit, construction risk
  - Contract Terms – cancellation, non-appropriation

Holding the Interest Rate

- After the spread has been determined the interest rate can be set
- The spread will not be constant in the time period between Proposal and receipt of Task Order
- The interest rate cannot be held during the time between receipt of Task Order and funding

Minimize Impact on Rate

- Time periods should be as short as possible:
  - Allow adjustment to spread / rate during evaluation
  - Fund into escrow
  - Include hedge costs in Project Costs

  Adding a "contingency" to the spread/rate is inefficient and too costly….

Hedging Interest Rates

- There are three basic methods to hedge rates:
  1. Forward Starting Libor Swap
  2. Swap Option
  3. Treasury Lock

Forward Starting Libor Swap

- A Forward Starting Libor Swap protects the borrower from higher UST rates and changes in corporate credit spreads:
  - Borrower determines locked level i.e. 10 basis points higher
  - At settlement borrower receives / pays cash from / to counterparty and Swap cancels
  - No up-front cost but credit approval needed

Swap Option

- The Swap Option allows the borrower to lock in an interest rate for a fee:
  - The wider the spread to current rates the lower the price of the Swap Option
  - At settlement, if rates have risen borrower exercises option and issues at the locked rate
  - If rates have fallen Swap Option expires

Treasury Lock

- A Treasury Lock does not protect borrower against spread volatility:
  - Borrower has the right to "sell" USTs at a date certain at the locked rate
  - At settlement borrower will either have a profit from selling the USTs (rates are higher), or a loss (rates are lower)
  - The profit / loss complements the lower / higher financing proceeds

Summary

I. Forward Starting Libor Swap

….most liquid market however must settle even if financing does not occur.

II. Swap Option

….costs are up-front but fixed if financing does not take place.

III. Treasury Lock

….cheap but not a good option if credit spreads are changing.